CIA/OER EIWA 74/03/28 UK: DISMAL ECON. PROSPECTS
C/NFD MAR 1974 01 OF 01

CIA/OER EIWA 74/03/28

Confidential
No Foreign Dissem

Annex to

Economic Intelligence Weekly

The United Kingdom: Dismal Economic Prospects

Confidential
CIA No. 8027/74/A
28 March 1974

Copy № 204

NATIONAL SECURITY INFORMATION
Unauthorized Disclosure Subject to Criminal Sanctions

Approved For Release 2000/04/18 : CIA-RDP85T00875R001500170004-0

THE UNITED KINGDOM: DISMAL ECONOMIC PROSPECTS

1. Britain's GNP will fall by 2% to 3% this year—the first decline since 1952. This contraction will result from weak domestic demand, the coal strike, and government measures to slow inflation. The drop in GNP will contrast sharply with last year's 6.5% rise, generated by Prime Minister Heath's consumption-oriented growth policy. In 1974 the United Kingdom will slump back into its usual position as the poorest economic performer among the major developed nations.

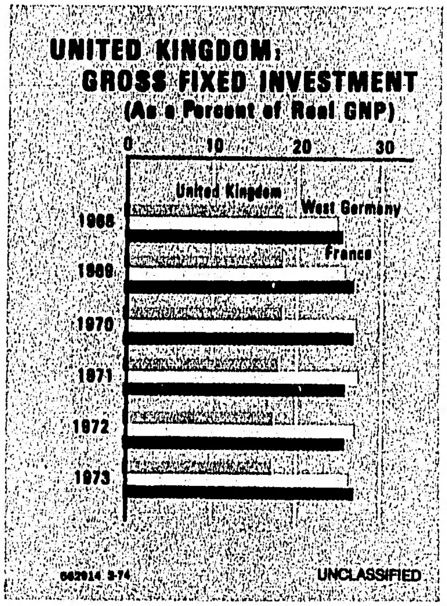
2. The Wilson government has chosen not to employ expansionary measures to deal with the recession because of Britain's rampant inflation and staggering trade deficit. It is relying on a tight monetary policy, increased food subsidies, and sizable overseas borrowings to cope with these problems. In the new budget announced Tuesday, Chancellor of the Exchequer Denis Healey moved to tighten fiscal policy by increasing taxes $1.6 billion more than expenditures. Higher corporate tax rates—together with surging costs for oil, raw materials, wages, and borrowed funds—will discourage business investment this year.

3. Even with more restrictive government policies, Wilson probably will be unable to prevent consumer prices from rising by about 15% and the trade deficit from more than doubling this year. The 30% pay raise recently granted to the coal miners and substantial gains in store for other workers guarantee considerable price increases. Prices also will be pushed up by the rippling effects of the 150% jump in the cost of imported crude oil since last September. At the same time the oil price hikes will add about $5 billion to the import bill, contributing to a record-breaking trade deficit forecast at $11.5 billion.

Recent Developments

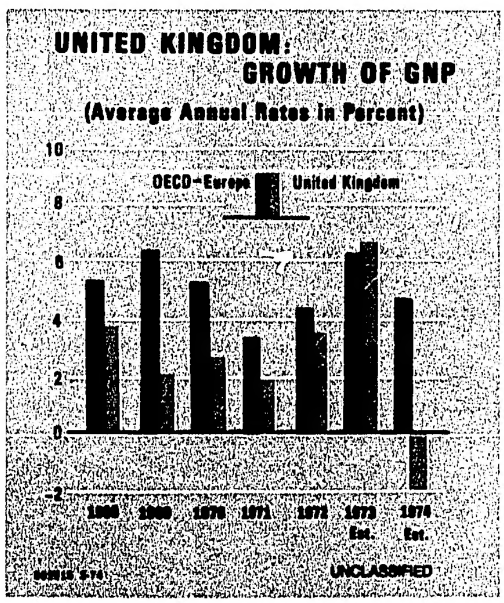
4. Before plunging an estimated 20% in the first quarter of 1974, Britain's industrial production had been leveling off for three quarters. Consumer demand, the source of the boom in late 1972 and early 1973, waned last summer as rising prices and wage restraints cut into real disposable income. Although demand has continued to contract, the sharp drop in first-quarter output resulted mainly from Heath's imposing a three-day workweek to conserve energy supplies. This step was considered necessary because the coal miners' overtime ban and subsequent strike, as well as the Arab oil supply cutbacks, threatened widespread power blackouts.

5. The fall in industrial production was smaller than the nominal cut in the workweek because some industries were exempted from short hours and others continued operation using electric power from their own standby generators. Shortened lunch hours and tea breaks, along with greater worker effort, also helped curb the drop in output. Because of its heavy dependence on coking coal, the steel industry was unable to benefit much from makeshift arrangments; it sustained a 40% decline in output by early March.



6. Domestic demand has not fallen off as rapidly as industrial production in recent months, despite restraints on installment credit and a dwindling of income as unemployment and reduced hours spread. Unemployment insurance, guaranteed-wage clauses in many labor contracts, and Stage III wage increases in some industries prevented the drop in consumer spending from becoming acute. Businesses generally carried on with investment projects under way before the energy crisis.

7. Export demand has held up comparatively well through the first quarter of 1974. Reflecting sterling's 9% depreciation (on a trade-weighted basis) since the beginning of 1973, the cost of British goods to foreign buyers has remained favorable and order books are full. Nevertheless, export volume—which rose substantially in 1973—fell in early 1974 because of production problems. The priority given by British companies to export orders, which are exempt from profit controls, did not keep the shortened



workweek from cutting into deliveries. Reduced export volume and the 150% rise in the cost of imported oil since September helped boost the trade deficit to a record $970 million in February.

8. Rising oil costs, substantial wage increases, and the growing gap between aggregate demand and output have intensified Britain's already severe inflation. Higher crude oil prices accounted for one-third of February's 1.7% jump in consumer prices. Even with the statutory wage-control program, wage increases averaged 13% during the 12 months ending in January.

Gloomy Prospects for 1974

9. In the budget presented on Tuesday, Healey initiated a tighter fiscal policy for the year starting 1 April. He earlier had argued that the contractionary impact of increased oil import costs and the Heath government's cuts in investment spending would not cut demand enough to materially reduce inflation and the trade deficit. The budget fulfills campaign promises to provide food subsidies, increase old age pensions, and improve other social security benefits. At the same time, it raises taxes on personal and corporate incomes and on the sale of certain luxury items, as well as broadening the coverage of the value-added tax. The resulting 20% cut in the budget deficit from last year's level will contribute to the anticipated 2%-3% drop in GNP.

Contraction in the Wind

10. In a few months, after inventories depleted during the three-day workweek are replaced, domestic demand probably will resume its downturn. The December 1973 level of production is likely to be restored in the third quarter, but output is unlikely to show substantial growth thereafter. Consumption will continue to fall as rising prices, credit controls, and higher taxes offset the stimulative effects of improved social security benefits. Export demand also will ease because of slowed economic growth in major markets resulting from normal cyclical factors and the contractionary impact of higher oil import costs.

11. Fixed investment—already a smaller share of GNP in Britain than in other industrial countries—probably will drop more sharply than GNP. Public investment will be reduced as a result of cuts in last December's budget revisions, which the Labor government is allowing to stand. Private investment also will decline because of the gloomy outlook for sales and profits. Even if the atmosphere were favorable, investment would be hobbled by increased taxes, high interest rates, and the depletion of working capital during the three-day week. Interest rates will have to be kept high, since Britain needs to attract foreign capital to help offset its huge trade deficit.

12. Such measures as the food-price subsidies will do little to contain Britain's skyrocketing inflation, given the sharply increased prices for imported oil and other commodities plus the sizable prospective wage gains. The oil price hikes of October-December will add about 2% directly to the consumer price index in 1974 and force it up indirectly, as well. The recent coal settlement will raise prices another 1% by pushing up electricity prices 30%. Although Stage III wage controls will not expire until fall, enforcement will be lax, and the example of the coal settlement will encourage high wage demands by other unions. In addition, threshold clauses in many wage agreements will ratchet wages upward as the prices rise. [redacted] 25X6
25X6 consumer prices will jump about 15% this year—an increase unlikely to be matched in most other industrial countries.

The Balance of Payments: Drowning in Oil

13. The United Kingdom's trade deficit will more than double this year. January's and February's record deficits will be topped in March under the full impact of oil price increases on imports and of the three-day week on exports. With Britain paying about $8.50 per barrel (f.o.b.), the oil bill will go up at least $5 billion in 1974, to around $8 billion. The adverse effects on imports and exports of the recently ended three-day workweek and of weakening world demand is likely to add $1 billion to the almost $3 billion deficit in non-oil trade registered last year. As a result, a record trade deficit of $11.5 billion is shaping up for 1974.

14. Britain will have to borrow abroad heavily this year, because only one-fifth of the trade deficit can be covered by net earnings from services and transfer payments. On Tuesday the government announced a $2.5 billion 10-year Eurocurrency loan and new restrictions on overseas investment. In addition, the United Kingdom can draw on about $3 billion in unconditional credits at the International Monetary Fund, as well as on a $3 billion credit swap line with the Federal Reserve Bank of New York. Substantial reflows of Arab oil earnings attracted by high interest rates are another likely source of funds. Britain nonetheless may be forced to dip deeply into its foreign reserves of $6 billion.

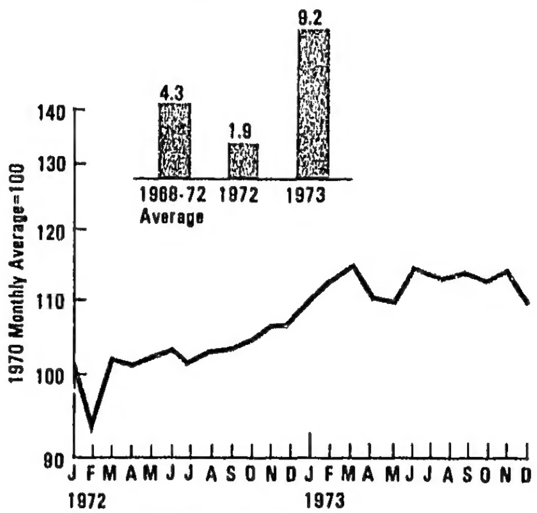
Little Cheer for the Average Chap

15. Private consumption will stagnate this year, as rising prices and higher taxes cut into real disposable incomes. The welfare measures in the new budget will improve the lot of Britain's lowest income groups at the expense of belt-tightening by the middle and upper groups. The average Englishman will have to pay more for his pint of bitters, cigarettes, off-track bets, candy, and gasoline as a result of tax changes. At the same time he will have to pay three percentage points more in his basic income tax rate. The rise in tax rates for top-bracket individuals will be still steeper, and Healey has promised to plug various tax loopholes.

UNITED KINGDOM: INTERNAL ECONOMIC INDICATORS

INDUSTRIAL PRODUCTION*

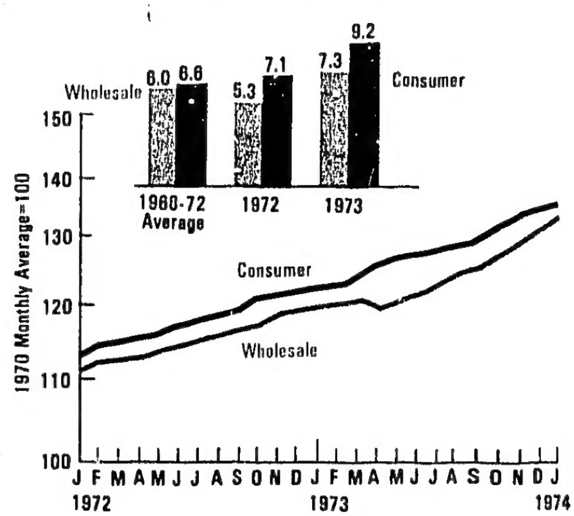
Annual Growth Rate (Percent)



*Seasonally adjusted.

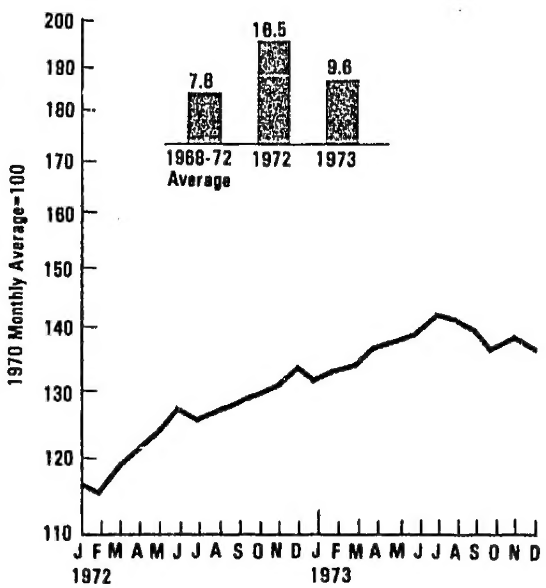
PRICES

Annual Growth Rate (Percent)



MONEY SUPPLY*

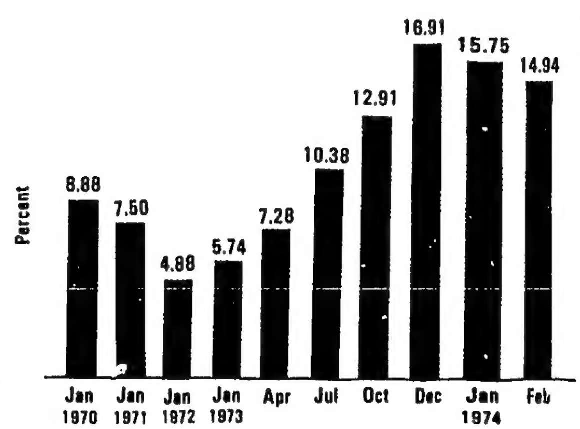
Annual Growth Rate (Percent)



*Seasonally adjusted. End of period.

MONEY MARKET RATES

Interest Rate for Local Authority Deposits

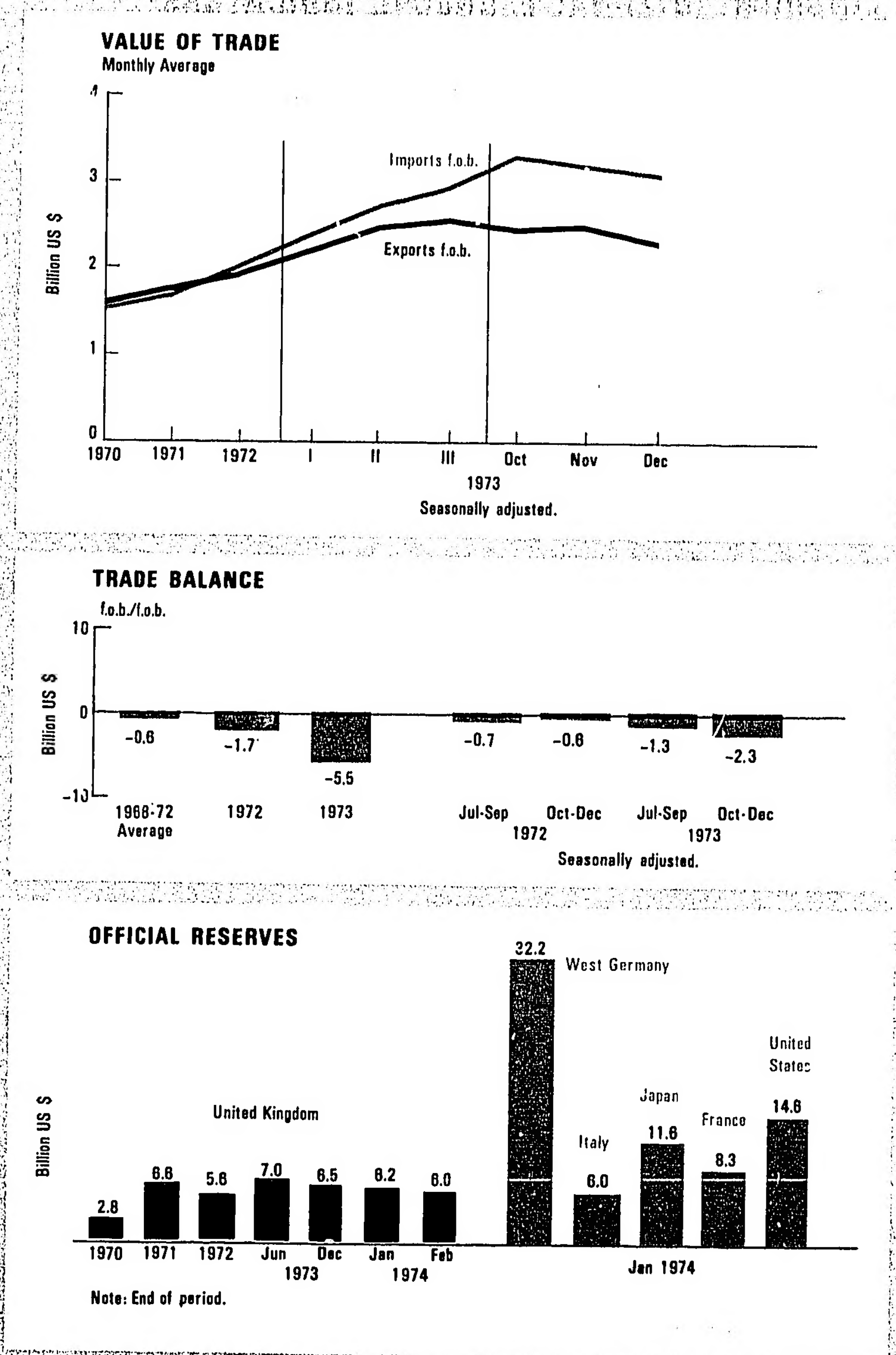


Note: End of period.

562003 3-74

UNCLASSIFIED

UNITED KINGDOM: EXTERNAL ECONOMIC INDICATORS

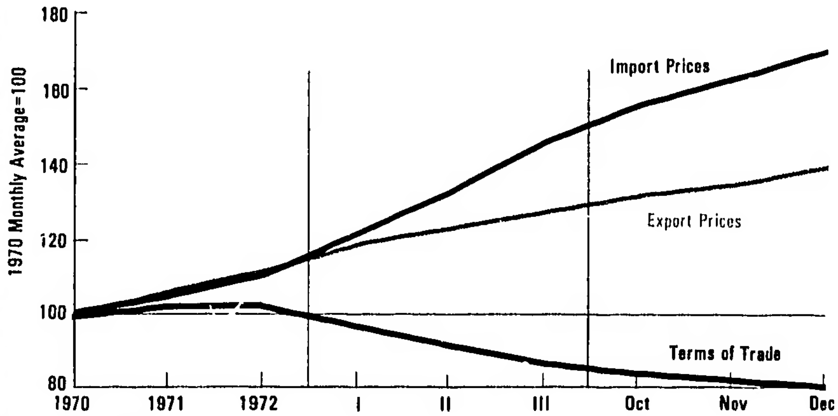


562904 3-74

UNCLASSIFIED

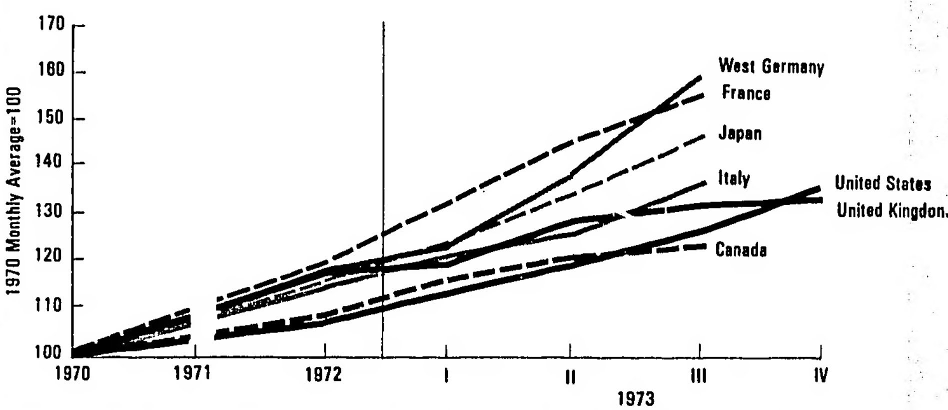
UNITED KINGDOM: EXTERNAL ECONOMIC INDICATORS

TERMS OF TRADE
National Currency

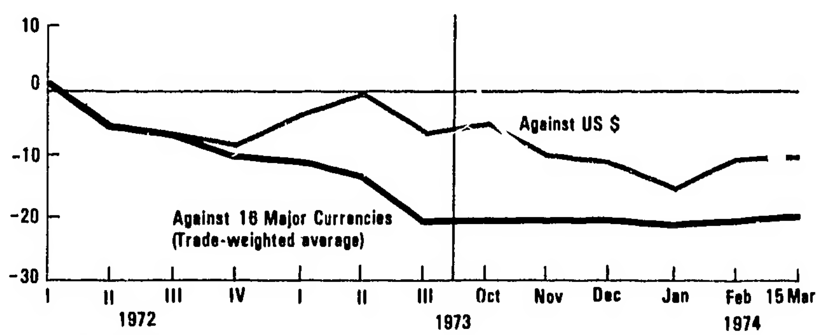


Note: Unit value indexes.

EXPORT PRICES IN US $



EXCHANGE RATES FOR THE BRITISH POUND
Percent Change from 18 Dec 71



Note: End of period.

562906 8-74 UNCLASSIFIED